Briefing on Inflation Report 2014-II

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İstanbul

Inflation Report: Main Sections

- Overview

- International Economic Developments

- Inflation Developments

- Supply and Demand Developments

- Financial Markets and Financial Intermediation

- Public Finance

- Medium Term Projections

Inflation Report: Boxes

- Revisions on Construction Investment Expenditures

- Capital Flows to Emerging Countries and Turkey in 2013: Effects of Fed Policy Change

- Forecasting of Exchange Rates using Yield Curves

- Foreign Currency Debt and Currency Risk of Firms in Turkey

Portfolio Flows

Portfolio Flows to Emerging Economies
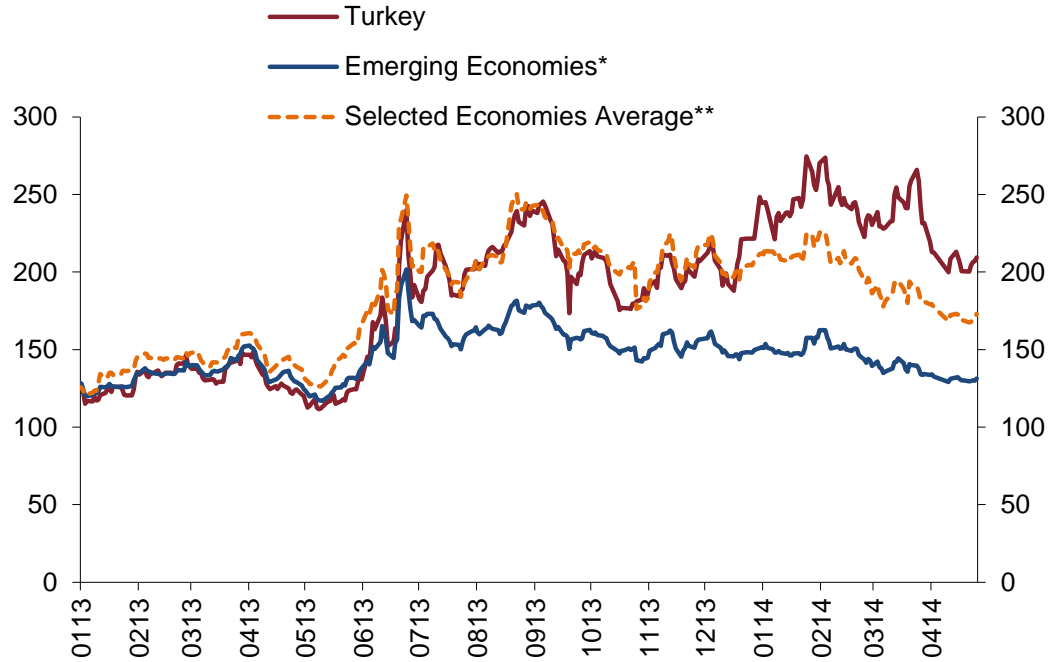### (4-week moving average, billion USD)
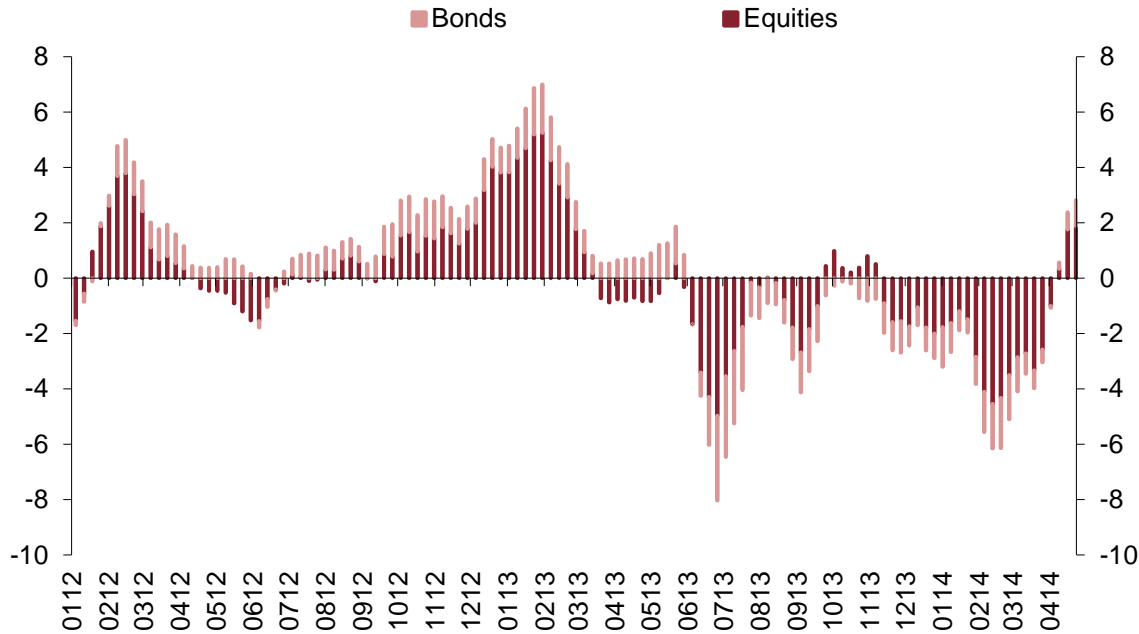
Source: EPFR.

In recent weeks, portfolio flows to emerging countries picked up slightly.

Risk Premium

CDS for Emerging Economies and Turkey
(Basis Points)

*Brazil, Czech R., Indonesia, S. Africa, Colombia, Hungary, Mexico, Poland, Romania and Chile.
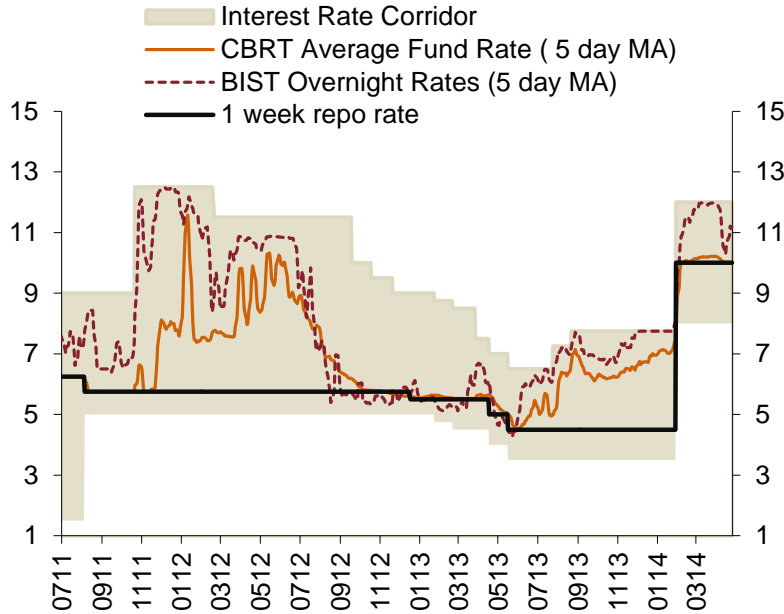** Brazil, Indonesia and S. Africa.
Source: Bloomberg.

➤ Recently, risk premium indicators for emerging countries displayed some improvement as well.

Monetary Policy and Financial Conditions

Monetary Policy

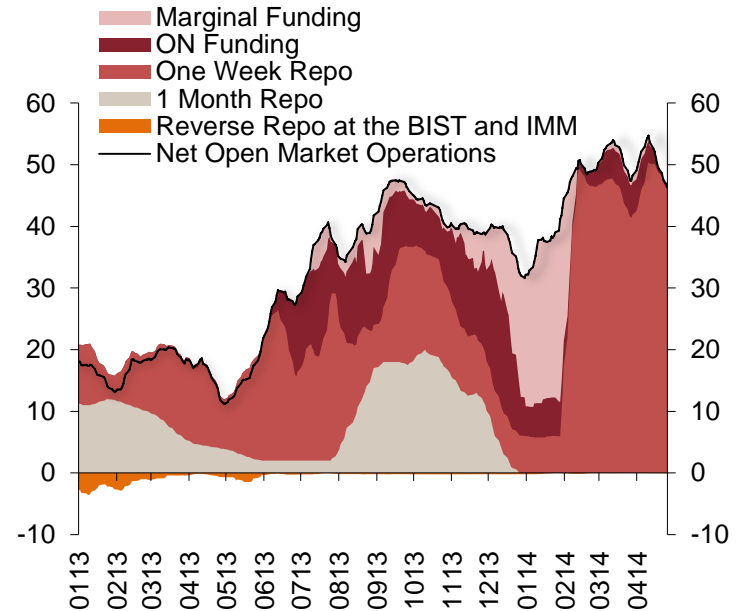## CBRT Rates and BIST Interbank O/N Repo Rates

(Percent)

CBRT Funding

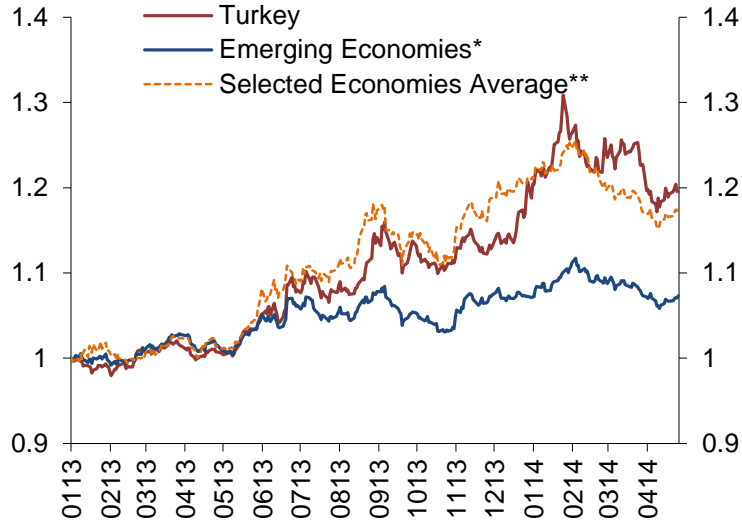### (2-Week Moving Average, Billion TL)

Source: BIST, TCMB.

➤ CBRT delivered a strong and front-loaded monetary tightening at its interim MPC meeting on 28 January 2014.
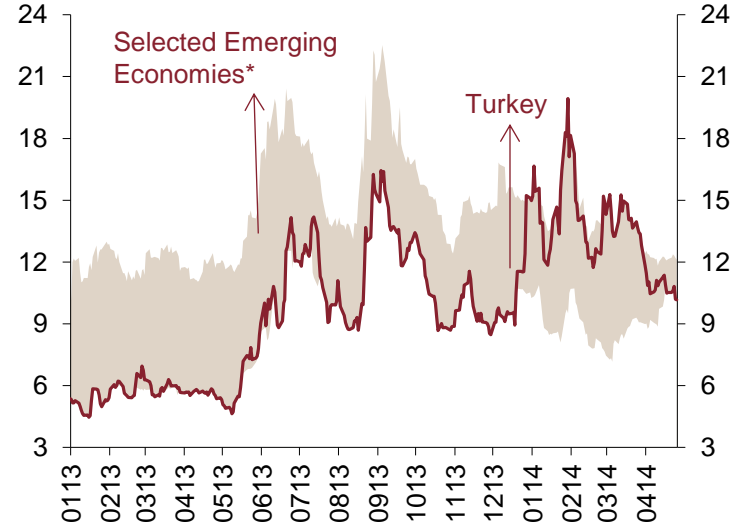
Exchange Rates

TL and Emerging Market Currencies vs USD
(01.01.2013=1)

*Brazil, Czech R. Indonesia, S. Africa, Colombia, Hungary, Mexico, Poland, Romania and Chile. ** Brazil, Indonesia and S. Africa.
Source: CBRT, Bloomberg.

1- month Implied Volatility of Exchange Rates
(1 month, Percent)

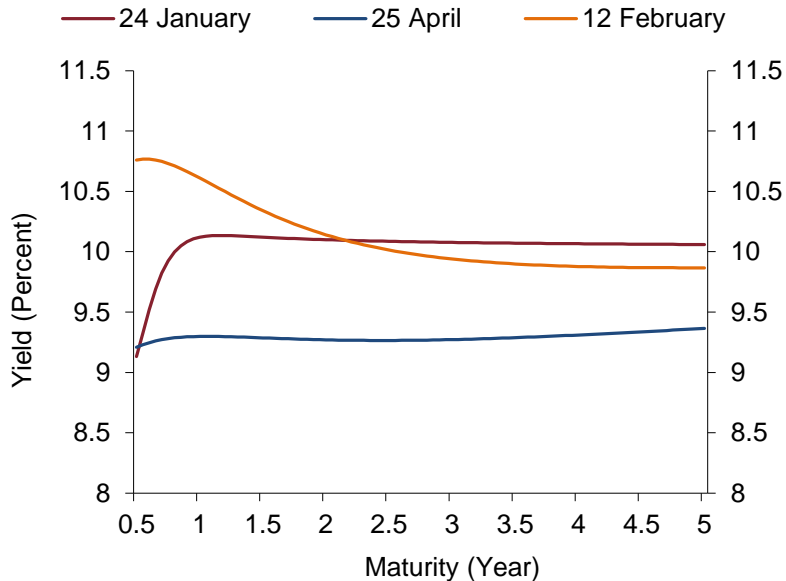*Selected EEs include Brazil, S. Africa, Indonesia, India and Turkey
Source: CBRT, Bloomberg.

➤ With the strong monetary tightening and the recent decline in uncertainties, Turkish lira appreciated and implied volatility decreased compared to similar countries

Monetary Conditions

Yield Curve*
(Percent)

— 24 January   — 25 April   — 12 February

*Calculated from the compounded returns on bonds quoted at the BIST Bonds and Bills Market by using ENS method.

Source: BIST, CBRT.

Benchmark Interest Rate and EMBI+ Turkey
(Benchmark Interest Rate Percent, EMBI+ Turkey Basis Point)

— Benchmark Interest Rate (percent)
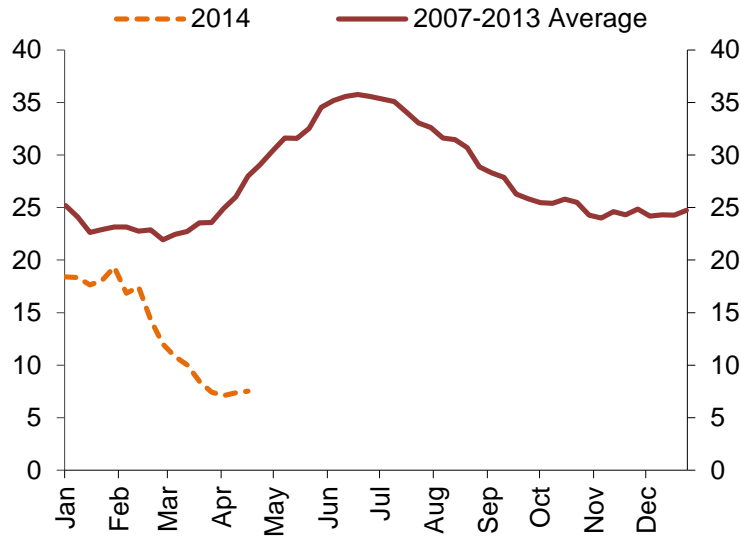
---- EMBI+Turkey (basis point - right axis)
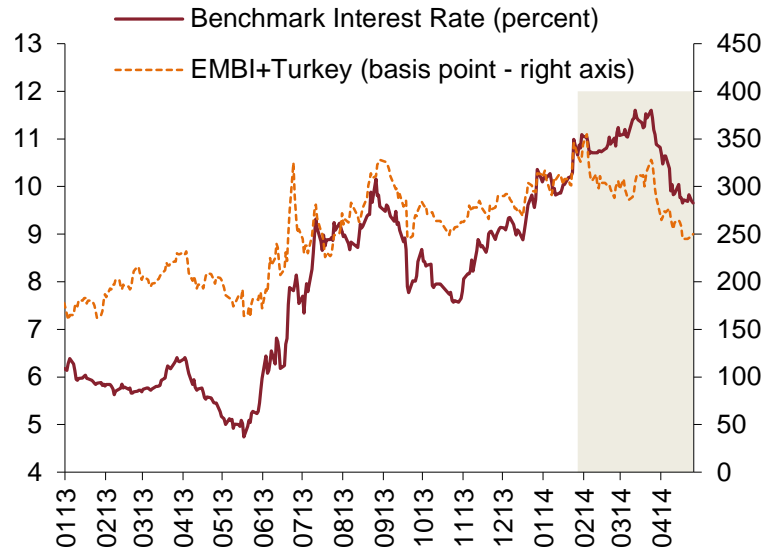
Source: BIST, Bloomberg.

➤ With the recent measures, improvement in risk premium and decline in uncertainties, interest rates in all maturities decreased.
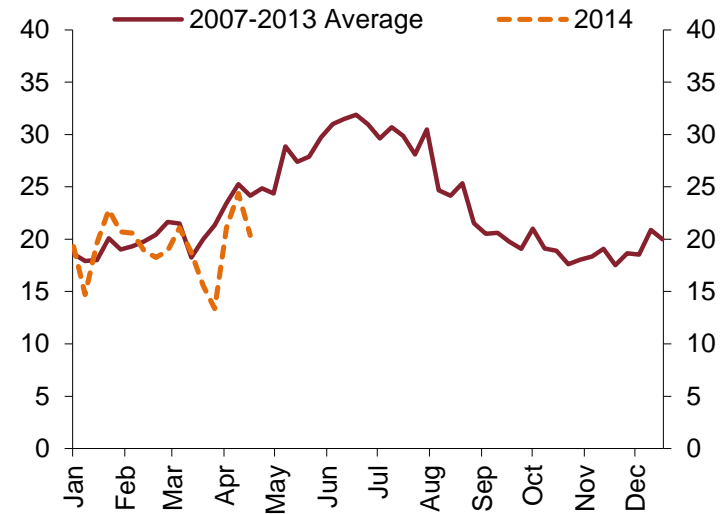
Financial Stability

Consumer Loan Growth
(13-Week Moving Average, Annualized, Percent)

Commercial Loan Growth
(13-Week Moving Average, Adjusted for Exchange Rate, Annualized, Percent)
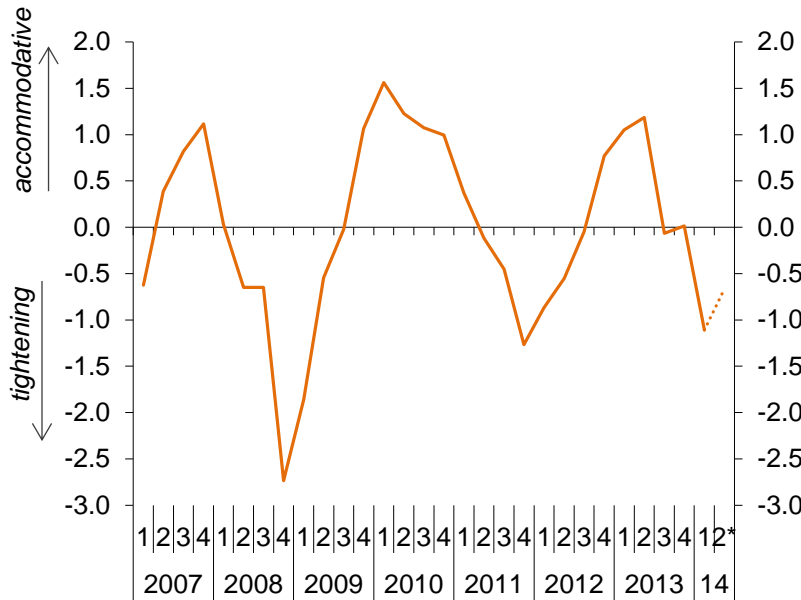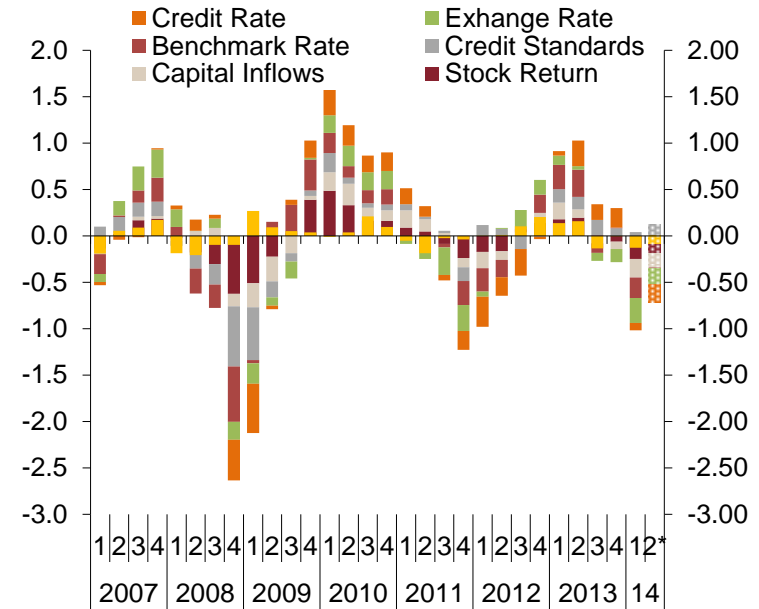

Source: CBRT.

Source: CBRT.

➤ Change in the credit composition supports the production and net exports.

Financial Conditions

Financial Conditions Index

Contributions to Financial Conditions Index

Legend:
- Credit Rate
- Benchmark Rate
- Capital Inflows
- Exhange Rate
- Credit Standards
- Stock Return

*Q2-2014 forecasts. The last value of FCI is a temporary calculation based on the first two week data of April . In this calculation, the latest values of the price variables are used, and loans standards are assumed to remain flat while net capital flows are assumed to show a pattern similar to Q2-2013. For further details on financial conditions index, see the CBRT Research Notes in Economics No. 12/31

➤ Financial conditions index supported the domestic and external stability in the first quarter of 2014.

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Macroeconomic Developments and Main Assumptions

January 2014 Inflation Forecasts and Realizations

January 2014 Inflation Forecasts and Realizations
(Percent)

January 2014 Inflation Forecasts and Realizations Excluding Unprocessed Food and Tobacco
(Percent)
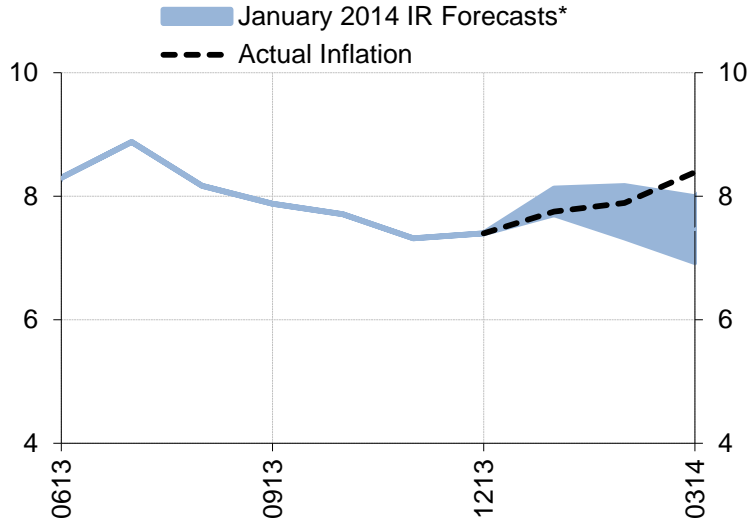
* Shaded region indicates the 70 percent confidence interval for the forecast.
Source: TURKSTAT, CBRT.
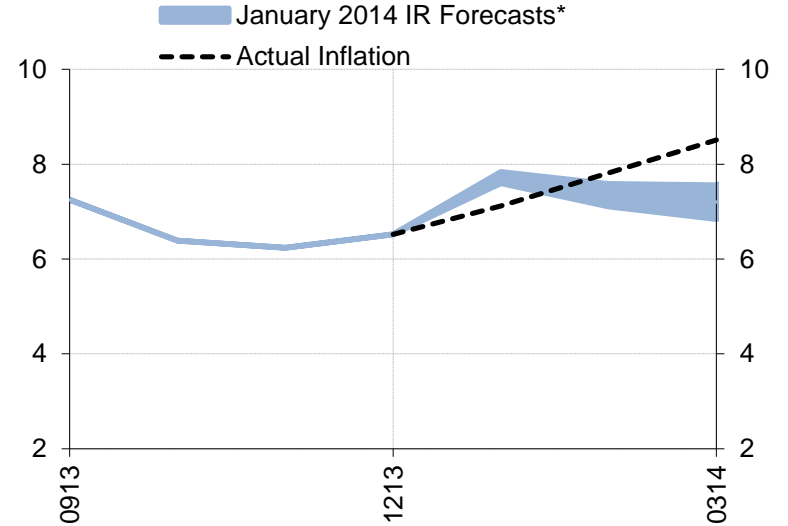
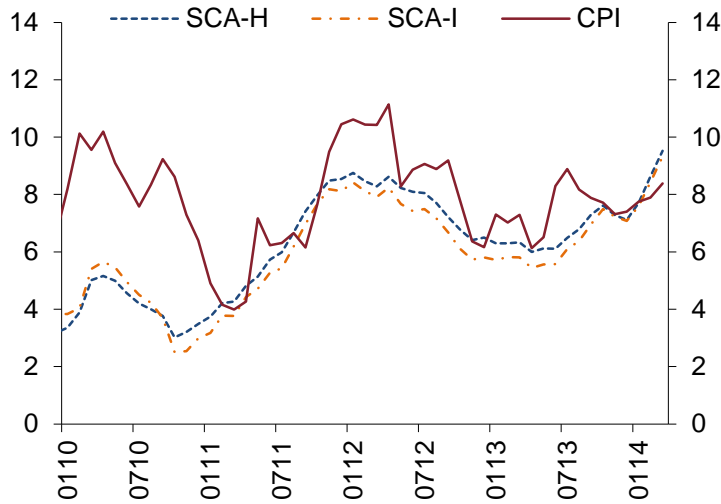➤ Consumer inflation increased to 8.39 percent in the first quarter of 2014, while inflation excluding unprocessed food and tobacco stood at 8.51 percent.
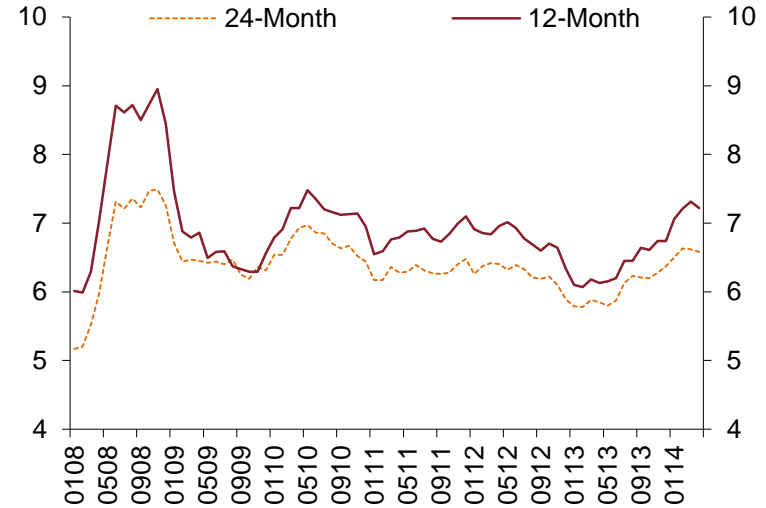
Inflation

CPI and Core Inflation Indicators
(Annual Percent Change)

SCA-H SCA-I CPI

Source: TURKSTAT, CBRT.

12 and 24-month Ahead CPI Expectations
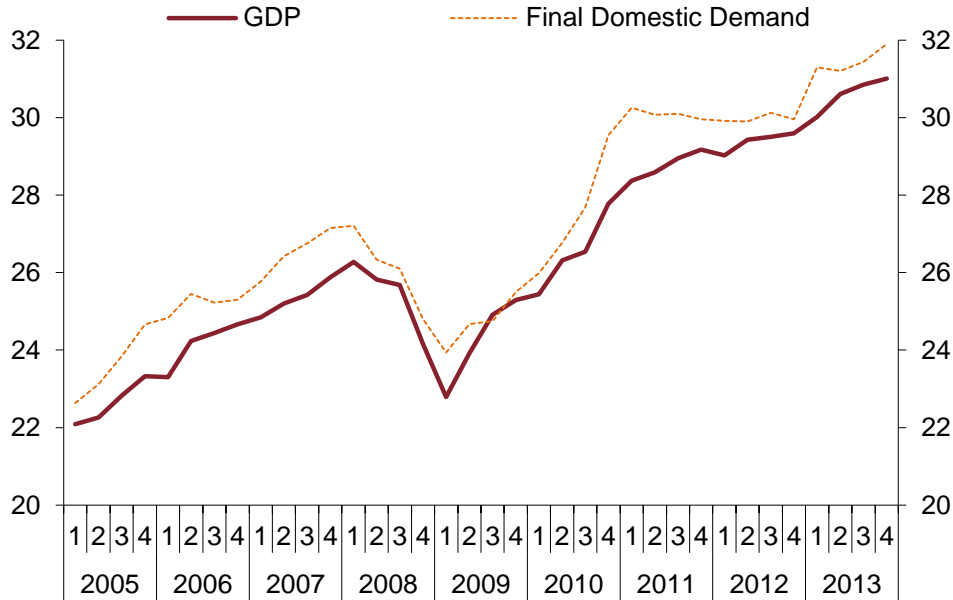(Annual Percent Change)

24-Month 12-Month

Source: CBRT.

➤ In the first quarter of the year, there was a significant increase in core inflation indicators.

➤ As of April , inflation expectations improved slightly.

Demand Developments

GDP and Final Domestic Demand

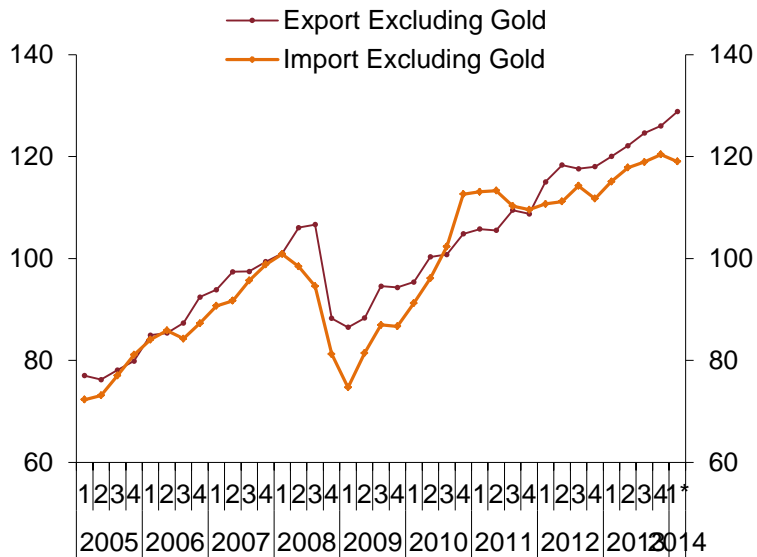(Seasonally Adjusted, Billion TL, 1998 Prices)

Source: TURKSTAT, CBRT.
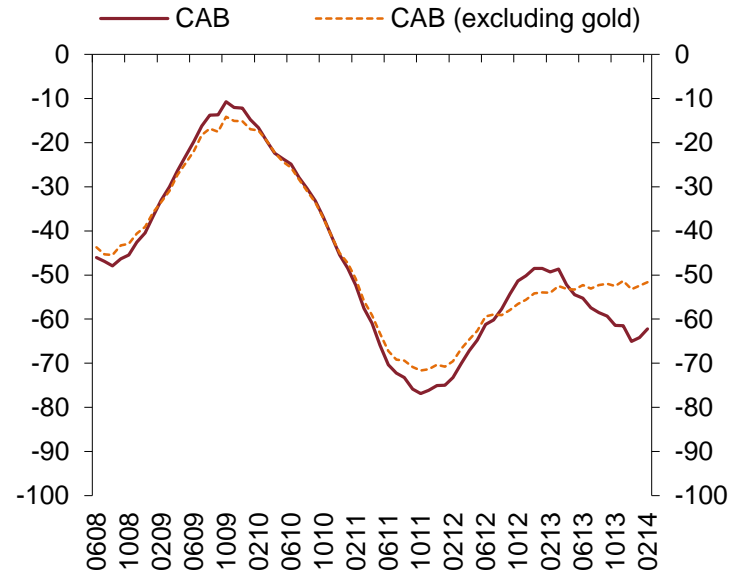
External demand is expected to support growth in 2014.

Financial Stability

Export and Import Volume Indices
(Seasonally Adjusted, 2010=100)

Current Account Balance
(12-Month Cumulative, Billion USD)

* First-quarter data reflects January-February realizations and March forecasts.
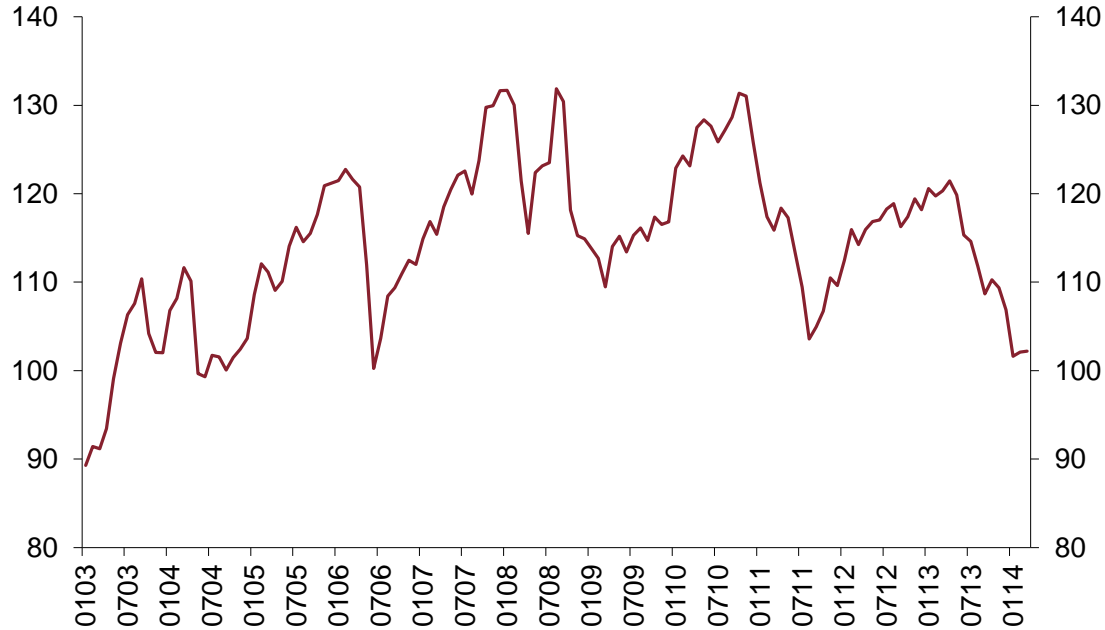Source: TURKSTAT, CBRT.

Source: TURKSTAT, CBRT.

➤ Rebalancing process in foreign trade and the improvement in current account balance continue.

Financial Stability

Reel Effective Exchange Rate
(CPI based, 2003=100)

Source: CBRT.

Recently, the volatility in exchange rates decreased.

Commodity and Import Prices

Oil Prices*
(USD/barrel)
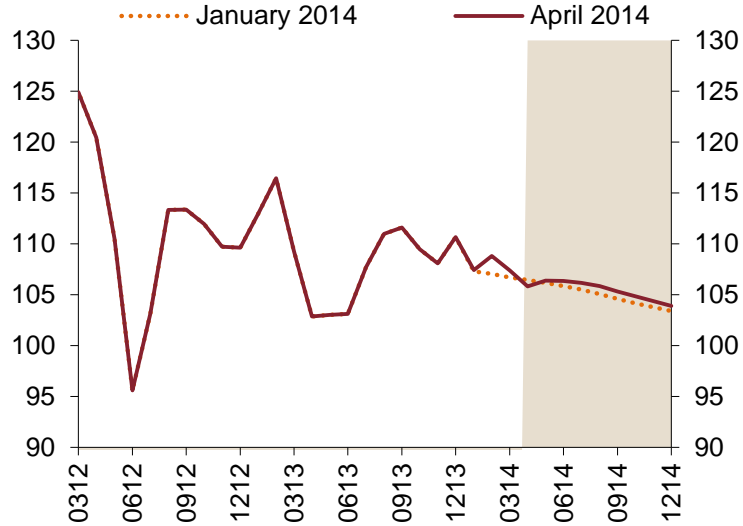
Import Prices*
(USD, 2010=100)

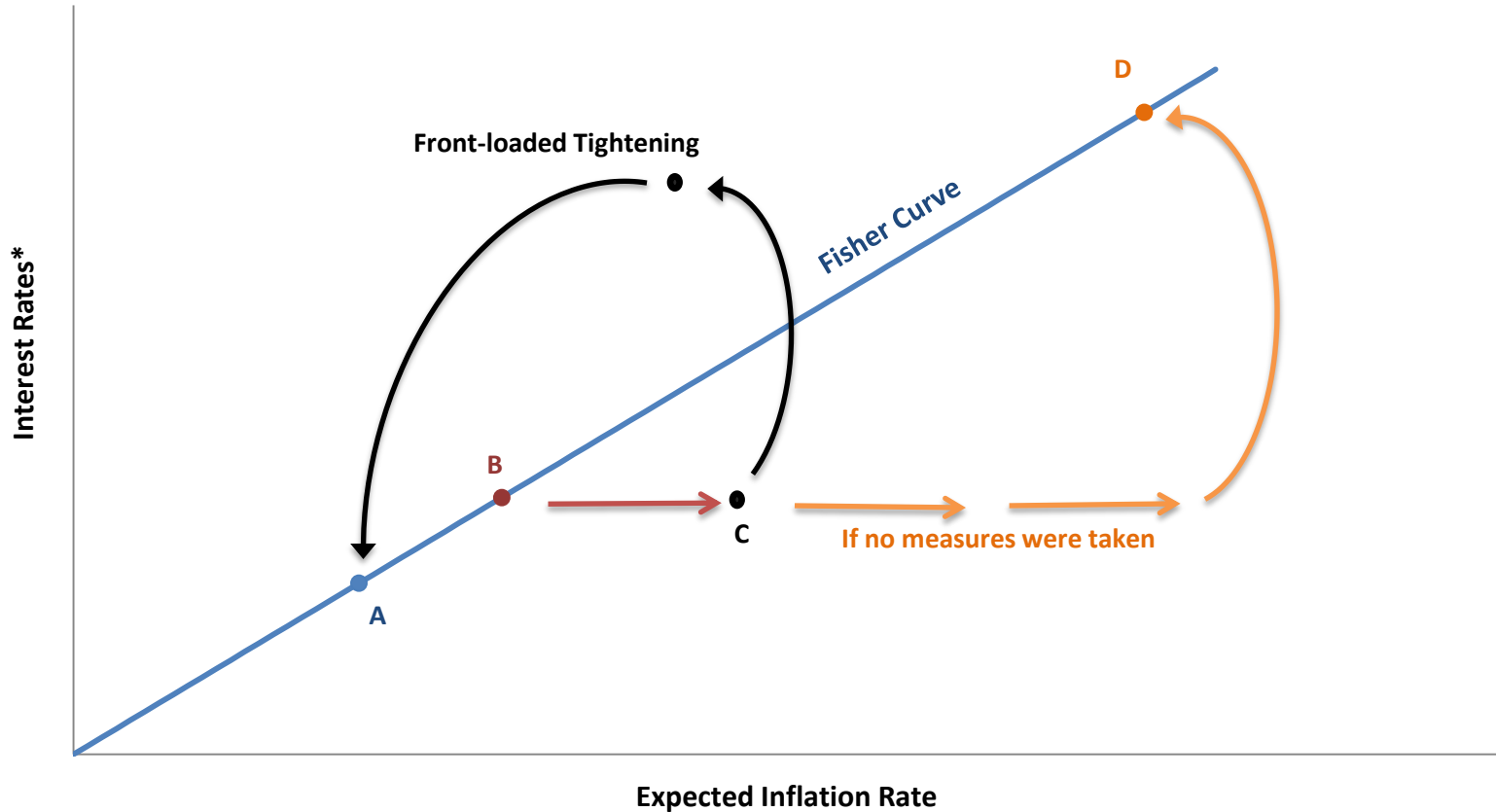* Shaded area indicates the forecast horizon.
Source: Bloomberg, CBRT.
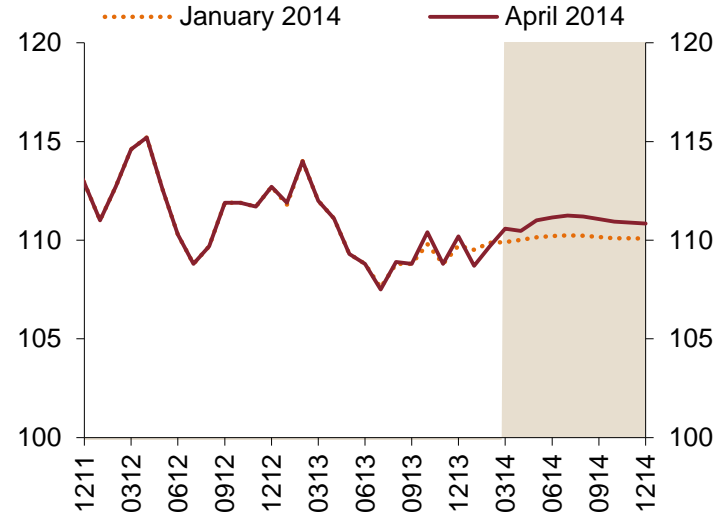
* Shaded area indicates the forecast horizon.
Source: Bloomberg, CBRT.

In the first quarter of 2014, oil and import prices proved mostly consistent with the January Inflation Report forecasts .

Monetary Policy Stance

- Medium-term forecasts are based on the assumption that the tight monetary policy stance will be maintained until there is a significant improvement in the inflation outlook and improvement in the risk premium indicators will be sustained.

- Moreover, it is assumed that the annual loan growth rate will near the level of 15 percent by the end of 2014 on the back of the adopted macro prudential measures.

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Monetary tightening delivered expected results.

Interest Rates*

Front-loaded Tightening

D

Fisher Curve

B

C

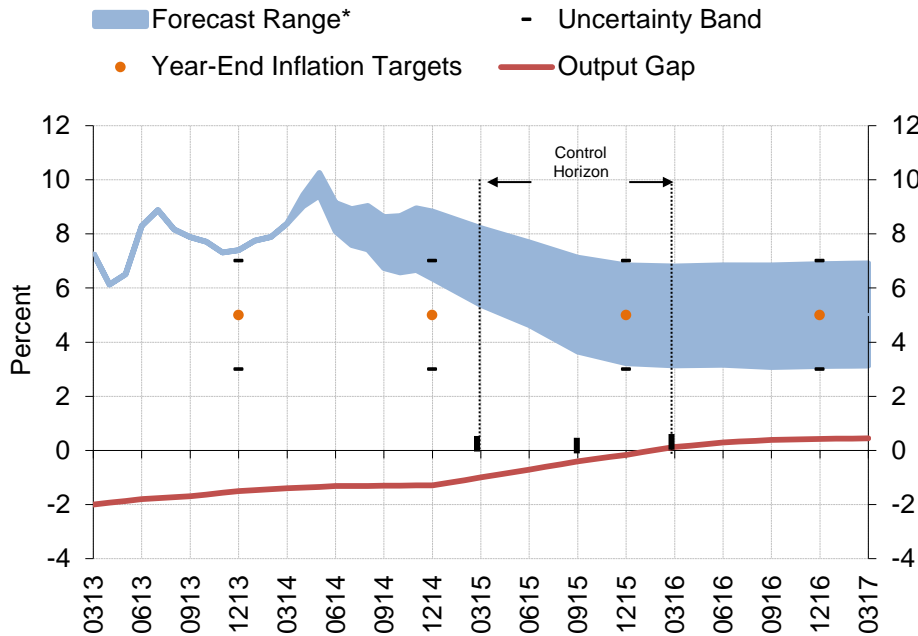**If no measures were taken**

A

Expected Inflation Rate

A: Inflation Target, B: Pre-shock Case, C: Inflation Shock
D: In Case of Delayed and Weak Policy Response.
*It represents long-term interest rates for Fisher curve, short-term interest rates for dynamic curves.
Maturity premium and risk premium are assumed to be zero.

Source: Stephen Williamson Blog, CBRT.

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Inflation Outlook - I

Inflation and Output Gap Forecasts

Forecast Range*
Year-End Inflation Targets
Uncertainty Band
Output Gap

Control Horizon

* Shaded region indicates the 70 percent confidence interval for the forecast.
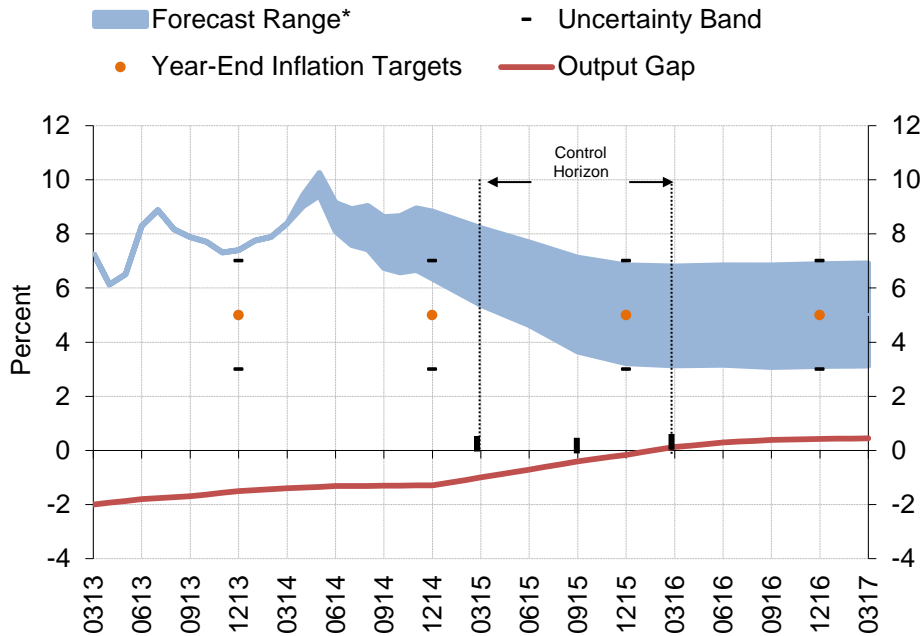
Accordingly, inflation is expected to

- **be between 6.4 % and 8.8 % (mid-point of 7.6 %) by the end of 2014,**

- **be between 3.2 % and 6.8 % (mid-point of 5 %) by the end of 2015,**

- **stabilize at 5 % in the medium term**

with 70 percent probability.

Inflation and Output Gap Forecasts

* Shaded region indicates the 70 percent confidence interval for the forecast.

Inflation is expected to decrease to 7.6 percent at the end of the year.

Revisions in the Assumptions

Sources of Revisions to end-2014 Inflation Forecasts	
Oil and Import Prices	+0.1 points
Food Prices	+0.3 points
Exchange Rate Developments	+0.3 points
Underlying Inflation Trend	+0.3 points

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